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INSURER FAILURES

Life/Health Insurer
Insolvencies and Limitations
of State Guaranty Funds

Statement of Richard L. Fogel, Assistant Comptroller General,
General Government Programs



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**INSURER FAILURES: LIFE/HEALTH INSURER INSOLVENCIES AND
LIMITATIONS OF STATE GUARANTY FUNDS**

Summary of Statement By
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GAO is testifying today on its recent report on the increasing failures of life/health insurance companies and the adequacy of protections for policyholders whose insurers fail.

The rate of failures for life/health insurance companies has increased substantially, as have the costs of such failures to state guaranty funds, policyholders, and taxpayers. Insolvencies in the industry averaged about five per year from 1975 through 1982. Since then, the average per year has more than tripled to almost 18, with 47 occurring in 1989 and 27 in 1990. The funds' assessments of insurers have increased more than ninefold from the period 1975-1982 to the period 1983-1989, from a total of about \$50 million to a total of about \$465 million.

While the costs of failures are covered initially by state guaranty funds' assessments of insurance companies, most states allow insurers to recover their assessments through tax offsets or rate increases. Therefore, the costs of failures are transferred to taxpayers and policy holders.

The increasing failures of life/health insurers have raised concerns about disturbing gaps in the collective "patchwork" safety net for policyholders. Although all states except the District of Columbia have guaranty funds, variations in state rules cause gaps and significant differences in coverage; specifically:

- There are different rules governing who is protected.
- Funds differ in the types of policies and annuities they protect.
- The amounts of claims and benefits covered differ.

In an insolvency of a multistate insurer, these differences can result in unequal treatment of policyholders of the same failed insurer. Indeed, some policyholders may have no protection. Furthermore, increasing assessments lead to concerns about the capacity of the funds to handle the greater burden that could result from additional insurer failures.

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our review of the failure rates of life/health insurance companies and the protections available to policyholders. Our report on the results of this work was prepared at the Subcommittee's request and is being released today.¹

THE INCIDENCE AND COSTS OF FAILURES HAS INCREASED

The number of insolvencies of life/health insurers has increased substantially in the past several years. From 1975 through 1982, insolvencies averaged about five per year. Since then, the average has more than tripled to almost 18 per year, with 47 occurring in 1989 alone and 27 in 1990. From 1975 through 1990, 39 states experienced insolvencies of life/health insurers, with 65 percent of the insolvencies occurring in 8 states--Texas, Indiana, Oklahoma, Louisiana, Arizona, Florida, Illinois, and New Mexico.

Even though the number of insolvencies peaked at 47 in 1989, this number represents only about 2 percent of the total number of life/health companies. Nevertheless, the increase during the 1980s was significant. These failures have resulted in many millions of dollars in rising costs to state guaranty funds, insurers, policyholders, and taxpayers. About \$50 million was assessed for insolvencies from 1975 through 1982. However, about \$465 million was assessed from 1983 through 1989, and in 1989 alone the total assessment was \$164 million. The costs of failures are covered initially by state guaranty funds' assessments of insurance companies. However, most states allow insurers to recover their assessments through tax offsets or rate increases that transfer part of the cost of failures to taxpayers and policyholders.

It is important to note that these assessment amounts do not reflect any assessments to cover costs of the very recent state takeovers of several large life/health insurers. The failure of the Executive Life Insurance Company of California and other large insurers could cause assessments to escalate even further, not only because of the companies' large sizes but also because of the diminished values of their invested assets.

PROTECTIONS PROVIDED BY LIFE/HEALTH GUARANTY FUNDS VARY AMONG THE STATES

In our review of the coverage provided by state guaranty funds, we found disturbing gaps in the collective "patchwork" safety net for life/health policyholders. When a multistate insurer fails,

¹Insurer Failures: Life/Health Insurer Insolvencies and
Limitations of State Guaranty Funds (GAO/GGD-92-44, Mar. 19,
1992).

some policyholders in some states can find themselves totally unprotected because of differences in the funds' rules of coverage. State funds differ in their policyholder eligibility rules, the types of policies they protect, and the limits they place on claims and benefits payments. Protections also can vary depending upon the financial health of the funds.²

Funds Have Differing Rules Governing Policyholder Eligibility

As of October 1991, six states followed a guaranty association model recommended by the National Association of Insurance Commissioners (NAIC) in 1970.³ This model covers all policyholders regardless of where they live when an insurer domiciled in the fund's state fails. It also covers the fund's state residents when a licensed insurer domiciled in another state becomes insolvent if that other state does not provide coverage.

The remaining state guaranty funds are generally based on a newer model set forth in 1985 by NAIC. This model provides coverage to state residents for companies licensed in the state, regardless of whether the company was domiciled in the state. It also provides coverage for nonresidents, but only if all of the following four conditions are met:

- the failed insurer was domiciled in the state,
- the failed insurer never held a license or certificate of authority in the state in which the nonresident policyholder lives,
- the nonresident policyholder's state of residence has a similar guaranty fund, and
- the nonresident policyholder is not eligible for coverage by the guaranty fund of the state in which the policyholder lives.

²The District of Columbia has no fund for life/health insurance, and its residents have no protection if a company domiciled there fails.

³NAIC was established by state insurance regulators to help coordinate insurance regulation by the states. Members include the heads of the insurance departments of the 50 states, the District of Columbia, and 4 U. S. Territories. Although NAIC develops and adopts model laws and regulations that the commissioners collectively believe necessary, it has no authority to require individual states to adopt these models.

According to NAIC, however, not all states have adopted the provisions for nonresident coverage and of the states that do provide for nonresident coverage some differ in their eligibility criteria. New York's guaranty fund, for example, will cover policyholders who are not residents of New York only if they purchased the policy while they were residing in New York.

For those holding a policy or contract with a failed company neither domiciled nor licensed in their state of residence, guaranty fund protection will depend solely on the laws of the state in which the company was domiciled.

There are many reasons why an individual might own a life insurance policy or an annuity from a company not licensed in the state in which they live. In our mobile society, many people move from state to state. There is no reason to believe that they would change their life insurance companies because of their moves. Others may live in one state and work in another where they purchase their insurance. It is also possible that purchasers of insurance through employer plans could live and/or work in states other than those where their employer is headquartered and in which the life insurance was originally purchased.

As you can see, the coverages recommended by the two models and the differences in coverage adopted by the various states are confusing. Consumers of insurance products seeking information on available protections face a formidable task in figuring out precisely what their coverage might be. But the reality of the bewildering patchwork of protections can only be fully understood by looking at the individual protections provided by the guaranty fund system when insurance companies fail. For this reason, as part of our work, we made an in-depth review of the differences and gaps in coverage resulting from six multistate failures.

In four of those six multistate failures, we found some policyholders were denied protection because of the differences in the state funds' rules of coverage. Some were not covered because they were ineligible for coverage in their state of residence and either ineligible or not covered at all by the state of domicile of their failed insurer.

In one insolvency we reviewed, some policyholders were denied coverage by both the fund in their own state and the fund in the state where their insurer was located. The fund in their own state denied coverage because, while the insurer had been licensed in the state, it was not licensed there at the time the policies were purchased. The fund in the insurer's state of domicile also would not cover those policyholders because nonresidents were covered only if the failed insurer had never been licensed in their state of residence.

In another insolvency, some policyholders were similarly not covered by their own state's fund because the insurer was not, and had never been, licensed there. However, the fund in the insurer's state of domicile also did not cover them because it had no provision to cover nonresidents who are not eligible for coverage by their states' funds as the NAIC model recommends.

Funds Differ in The Types of Policies and Annuities They Protect

Guaranty funds cover claims and benefits for most, but not all, types of life and health policies and annuities. Most funds exclude policies or coverage provided by entities that do not fit the pattern of a traditional insurance plan, such as health maintenance organizations, Blue Cross/Blue Shield plans, fraternal benefit societies, and self-insured employer-sponsored benefit plans. In some cases, these types of plans are not covered by the guaranty funds because they operate under a different level of state regulatory supervision than other, more traditional, insurance companies.

State guaranty funds also vary substantially in their coverage of so-called unallocated annuities--investment contracts typically purchased by businesses and state and local governments to fund portions of their retirement plans. Employees participating in plans with guaranteed investment contracts from failed insurers may see losses in their retirement benefits in proportion to the amount of their retirement benefits to be derived from these contracts. For example, New York-based holders of guaranteed investment contracts from Executive Life Insurance of California would not have guaranty fund protection from either the New York fund or the California fund. The New York fund covers unallocated annuities, but only for companies licensed in the state. Executive Life Insurance of California was not licensed in New York. California coverage is unavailable because the fund does not cover those contracts. On the other hand, a Washington-based pension fund holding this same type of contract with Executive Life of California would receive up to \$5 million from that state's guaranty fund, which covers unallocated annuities up to that amount.

As of April 1992, 19 states provided limited coverage for unallocated annuities, 2 of them because of court orders resulting from legal challenges; 17 specifically excluded these types of annuities from coverage. The remaining states neither included nor excluded such coverage, leaving the matter to be resolved, when necessary, through litigation or revisions to the guaranty laws.

Funds Differ in Amounts They Will Pay in Benefits and Claims

Rules limiting the amount of benefit and claim obligations of state guaranty funds vary state by state. For this reason, two policyholders in different states with guaranty fund coverage for the same insurance policy or contract may receive different payments. The current NAIC model recommends maximum benefits per individual of \$100,000 in cash values of life, health, and annuity benefits; \$300,000 in death benefits; \$100,000 in health insurance benefits; and a \$300,000 maximum for all benefits regardless of the number of policies or contracts an individual holds. At this time, 18 state funds use the limits set in the current NAIC model. Twelve other funds follow an older NAIC model that limits all cash value payments to \$100,000 and the total for all benefits to \$300,000 per individual.

The remaining funds vary from these amounts and many do not set specific limits for individual types of policies or contracts. For example, New York and Washington limit total benefits for covered policies to \$500,000. Wisconsin and North Carolina have total benefit limits that may not exceed \$300,000. Kansas has a limit of \$100,000 on a life policy, \$100,000 in health benefits, and \$100,000 in annuity benefits, but total benefits may not exceed \$200,000. California, which has one fund for life insurance and annuities and another for health insurance, guarantees 80 percent of benefits but limits them to not more than \$250,000 in life insurance death benefits and \$100,000 cash values, but not more than \$250,000 for total benefits. By contrast, Maryland has no limit on its fund's obligations on covered policies.

The holders of policies or annuities whose values exceed the established limits may seek payment as creditors through a claim on the failed insurer's estate, which is handled by a liquidator. In one insolvency we reviewed, annuity values exceeded guaranty fund limits by more than \$6.8 million. However, in many cases, the payments to creditors by the estate of the failed company may be limited to only a fraction of their value. Such payments may also be delayed for a substantial period of time while the estate is settled.

Limits on coverage for unallocated annuities also vary among the states that provide such coverage. Eleven states cover up to \$5 million and 5 up to \$1 million per contract holder, regardless of the number of contracts held or the number of individuals that may be covered by them. New Jersey will cover up to \$2 million per contract; consequently, if a company or pension plan held five separate contracts with a failed insurer, coverage would extend to a maximum of \$10 million.

Fund Limitations on Continued Coverage

Unlike property/casualty insurance coverage, health, life, and annuity contracts are long-term arrangements. When a failure occurs, however, some insureds may have bad health or be at an age where they are unable to obtain new and similar life or health insurance coverage. For this reason, the life/health guaranty funds are required to provide a limited measure of continued insurance coverage. A fund can provide the continued coverage itself or through third-party administrators or place coverage with other insurance companies. When an insurer that operates in more than one state fails, a committee of funds that operates under the auspices of the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) tries to place or reinsure all or part of the remaining business with another insurer. This committee was established in January 1990.

For group policies, NAIC's current model recommends that existing benefits be continued at the same premium rate until the earlier of the next policy renewal date or 45 days. However, in any case, coverage must be continued for at least 30 days after the date that a fund begins to provide benefit coverage in order to allow time for replacement of the insurance. In some states this 30-day clock begins running when a company is determined to be impaired, in others it begins when a company is formally ordered into liquidation. For individual policies, the model recommends that benefits be extended until the earlier of the next renewal date or 1 year, but, again, not less than 30 days from the date the fund became obligated for such policies.

The failure of a life/health insurer can result in cancellations or changes in policies for some policyholders. If individuals formerly under group policies had a right under law or the terminated policy to convert coverage or continue a policy until a specified age or time, substitute coverage must be found or offered by the guaranty fund. The premium and benefits of the substitute coverage may be different from those the insolvent insurer had offered, but they must meet a minimum standard prescribed by state statutes. This minimum varies by state.

Individual--as opposed to group--life and health policies of the failed insurer that cannot be placed with another insurer are usually cancelled. Some of the policyholders may be unable to obtain new health or life insurance. Even if they get new insurance, they may lose coverage for pre-existing health conditions.

Funds Differ in Their Assessment Capacities

The amount each state guaranty fund can assess any insurer each year is limited by law. The majority of states have limits set

at 2 percent of premium income; eight states set limits at 1, 3, or 4 percent. As insolvencies occur, the funds estimate the amount needed to pay claims and benefits. The funds then assess their member companies a percentage of their premium income from the line of business (life or health, for example) for which the fund is making assessments.

Although few insolvencies have caused state guaranty funds to exceed their assessment limitation, the recent takeover of several large life insurance companies has raised concerns about the funds' ability to handle one or more large company failures. According to NOLHGA officials, the total nationwide assessment capacity for 1990 was approximately \$3 billion (\$1.1 billion for accident and life insurance, \$784 million for annuities, and \$1.2 billion for health insurance). However, as indicated, the maximum amounts that can be assessed in a single year vary among the states. Individual state funds may not have sufficient capacity to handle an increasing number of insolvencies or the insolvency of one or more large insurers.

To cope with shortfalls, the funds may use a variety of strategies. For example, a fund may repeat assessments in subsequent years if its limits are reached; however, this can result in partial or delayed payments of policyholder claims and benefits. Funds may also use moratoria or other restrictions on payments to stretch their assessment capacities, but these strategies, too, may result in payment delays for policyholders. Finally, a guarantee fund may also borrow funds to pay claims until additional assessments can be made. This strategy reduces the delays in payments of claims and benefits, but it adds to the ultimate cost of an insolvency.

CONCLUSION

In sum, our review of guaranty fund coverage reveals significant gaps in the safety net for life/health policyholders. The gaps are caused by variations in the rules and coverage criteria of the state guaranty funds. The protections the funds provide can also vary depending upon the financial health of the fund. With the rising number of failures of small insurers and the recent regulatory takeovers of large life/health insurers, there is a growing likelihood that even more policyholders than in the past will face the prospect of falling through the safety net and landing without the benefits promised by their insurers.

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Mr. Chairman, this concludes my prepared statement. I will be pleased to answer questions.

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